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The Loose Money Boom

"As the nation's spirits have risen apace with the Dow, the economy has flourished, corporate coffers have swelled, payrolls have expanded hugely, and so have capital gains - all of which have mightily strengthened the flow of revenues into the Treasury's vaults and magically reduced the deficit to less than 1 percent of GDP, from nearly 4 percent in the early years of this decade. Forget all that blather about fiscal discipline, mean-and-lean managements, minuscule inflation, and give credit where credit is due: to the bull market."

"All Bull", Alan Abelson, Barron's, June 23, 1997

The most obvious possible dangers to today's global financial bubble are nowhere to be seen: we do not foresee economic overheating and the onset of consumer price inflation in the U.S., nor a series of rate hikes by the Fed. Instead, we see continued worldwide monetary looseness. And how could it be otherwise? After all, it is not sustainable robust economic growth that has driven the financial markets to new heights, but economic malaise.

Financial deregulation and globalization combined with the 2 percent growth of the 1990s has helped keep money loose. And the fact that this glut of money and credit has been channeled overwhelmingly into the stock and bond markets has given most observers the only comfort they need: a secure, low CPI. It remains of no importance to these observers that unprecedented inflation is in the financial markets — as the prices of stocks and bonds far outpace the profit performance of the underlying companies.

In this month's letter, we analyze the underlying causes of this global bull-run in financial assets and we provide new evidence of the speculative nature of the markets by demonstrating the increasing disparity between share price performance and underlying profit growth as reported in the national income accounts. We also review the turmoil in the Southeast Asian currencies, and consider the resultant likely weakening of the dollar standard. Finally, we identify the euro's most likely competing fates at this point: a euro that is "wide and soft" versus one that is delayed. We anticipate delay — perhaps an indefinite one.

PRICE STABILITY CONTRA FINANCIAL STABILITY

With moderating economic growth, invariably favorable inflation data, and respectable profit reports, there was some concern in the markets that Mr. Greenspan might spoil the party again with new hints at "irrational exuberance". In consideration of the bashing he had taken for this remark last December, some verbal temperance, though, was expected. To the consternation of bears and bulls, he instead seemed to corroborate the rosy assumptions underlying Wall Street's euphoric perception of a "new" economy.

Today pundits calmly explain how these truly spectacular market gains are quite commonplace and unremarkable — and certainly not speculative — for such ideal conditions. In our view, things have gone from craziness to outright madness. In obvious disagreement with the majority, we just can not imagine a more speculative environment. Many valuations have gone from highly excessive to outright absurd.

Recently, Microsoft, with a market cap now of $200 billion, gained 10 points in a single trading session on no news whatsoever — an incredible market cap gain of over $12 billion, or almost equal to past year's revenues. Dell Computer, a successful operator in an increasingly competitive PC industry, has gained 40 percent during the past month, bringing its market cap to a silly $28 billion. IBM's spectacular stock, up another 15 percent during the past month and now sporting a 12 month stock gain of 100 percent, is in contrast to recently reported second quarter revenues and operating income, which grew only 4 percent and 2 percent, respectively. The semiconductor/SOX Index has added another 15 percent during the past month to increase its year-to-date gains to almost 50 percent while the NASDAQ 100 has added another 16 percent, raising 1997 gains to 34 percent. These are but a few of the more visible examples of speculation gone to extremes.

Recent astonishing gains are a continuation of the strong markets experienced the past several months: the apparent main factor was the waning fear of Fed tightening. Interestingly, in a continuation of the trend in place for some time, the most spectacular gains continue to be in a relatively small group of blue chips, especially the large technology stocks. The small cap Russell 2000 has 1997 gains of only about 10 percent, compared to 34 percent for the NASDAQ 100, which is dominated by the large technology companies. In fact, we were fascinated by some insightful statistics, compliments of CNBC. In regards to the percentage of stocks within a particular index with gains so far in 1997, the Dow has seen 90 percent of its 30 stocks positive for the year; S&P 500, 83 percent; and the New York Stock Exchange Index, 77 percent. At the same time, only 55 percent of NASDAQ stocks are in the plus column so far this year, and, within NASDAQ's technology sector, just 44 percent are up. Specifically, fully 500 of the 970 technology stocks within the NASDAQ composite have declined so far this year.

Notwithstanding Wall Street's and the media's focus on the success of a small number of technology leaders as justification for the endless push of technology theme investing, we would argue that our expectation of deteriorating underlying industry fundamentals is being increasingly confirmed by the poor performance of hundreds of technology companies. It remains our belief that the technology sector is ripe for great disappointment.

Looking at actual and potential money flows and with nothing but further central bank looseness ahead, it is difficult to make an impending bear case. All this has certainly lasted much longer and gone to greater excess than we ever thought possible. We see many analogies with the U.S. stock market boom in the late 1920s and with Japan's stock market boom in the late 1980s, but we don't see a central banker who regards runaway inflation in financial markets as an evil that has to be restrained. In our view, constant careful monitoring of the danger spots in this development are needed all the more.

THE DEATH OF THE BUSINESS CYCLE

Watching the flyaway global stock markets, we often think to ourselves: "The business cycle is dead; long live the bubble economy". In late 1989, early 1990, Japan's central bank consecutively hiked its interest rate with the explicit intention of deflating the speculative bubble that it had fueled for years with loose money. It was the first and only time in history that a central bank has done this deliberately, albeit with near-zero consumer price inflation. The reasoning behind the action was that it had to be done before the boom would burst on its own accord more violently and from an even more extreme level of overvaluation, unleashing even greater damage on the banking system and the economy. Most probably, though, the central bank had grossly underestimated the destructive effects that the bursting of the bubble would actually have on the financial system and thereby on the whole economy. Quite clearly, there was little understanding of how maladjusted things had become.

All of which keeps critical observers agonizing: where is the limit to the present global runaway financial

boom if the central banks around the world keep their money spigots wide open on the premise that their one and only legitimate task is the stability of consumer and producer prices? By this rule, conventional inflation rates, being in general at their lowest since the 1960s, appear to provide virtual certainty that the central banks remain accommodative whatever happens in the financial markets.

But what about the stability of the financial systems that is jeopardized by such unlimited tolerance of asset bubbles? Isn't a sound financial system unquestionably more critical for the well-being of an economy in the long run? One should think that Japan's recent disastrous experience ought to have brought this insight dramatically home, at least to central bankers. With its far superior savings and investment ratios, Japan's economy is endowed with the strongest growth fundamentals in the world, yet its bubble-ravaged financial system has been spreading paralysis for years.

Watching the markets, three questions are foremost in our mind: First, where is the limit to this financial mania against the background of permanent monetary looseness? Second, what is its initiating force: economic success or overabundance of funds available for financial speculation? Third, what are the longer-term implications?

IN SEARCH OF A MIRACLE

Every boom has two different potential causes: first, economic success; and, second, overly loose money creating an imbalanced "bubble economy". The historical experience is that "bubbles", however big, are recognized too late. It lies in their nature that they first give the appearance of great economic strength, for which many want to take credit. When in 1927-29 Wall Street zoomed and the economy boomed, the bulls invented the term "New Era". It was supposed to say that the U.S. economy had entered a new era in which old economic laws and valuation gauges for equities were suspended.

Indeed, the U.S. economy had performed magnificently in the roaring 1920s. The most striking features were persistent zero inflation, fabulous productivity growth in manufacturing and agriculture, and the financial boom. The three occurred against the backdrop of very strong real GDP growth, averaging 6 percent annually during the eight years from the recession trough in 1921 to 1929. This was achieved with a 1.5 percent growth rate in employment and a 4.5 percent growth rate in productivity. With such prodigious productivity gains, the strong GDP growth was easily compatible with virtual price stability.

Judged by these numbers, it was not so absurd to speak of a "New Era". New was in particular the notion that this productivity growth and the associated zero inflation were assuring the prospect of perpetually easy money. The trouble was that this specific notion inspired Wall Street to recklessly speculative ventures on an unprecedented scale. The greatest excesses occurred in 1927-29, after the Fed had eased. According to a report from the United Nations (The Course and Phases of the World Economic Depression, published in 1931), no less than 86 percent of the total increases in bank credit in the United States during this period went into the financing of speculation. That, and not the high productivity growth or the low inflation, was the true foundation of the stock exchange boom and other financial excesses.

Turning now to the current U.S. economy and its performance over the last years, again unusual euphoria reigns. Profits are strong, jobs multiplying, unemployment the lowest in the world, inflation quiescent, the stock market booming, and product quality much improved. Wall Street has labeled it the best of all worlds for the U.S. economy and its financial markets.

What, indeed, are the underlying causes of this exceptional performance and is it really as good as perceived? Has the long-promised supply-side miracle at long last materialized for the U.S. economy, beneficially blending

strong economic growth with steady low inflation, and on top of this rich business profits? Or are these attractions perhaps the glowing signs of a "bubble" economy? Not to forget: less than ten years ago Japanese corporations and the Japanese economy enjoyed the very same mystique of superior efficiency and invulnerability, while the Japanese banks looked destined to dominate global finance.

Actually, the admiration for Japan's economic performance at the time certainly made a lot more sense than the present exuberance about the U.S. economy. While Japan has by far the highest savings and investments among the industrial countries, the U.S. economy has among the lowest. While Japan has a huge, chronic trade surplus, the United States has a huge, chronic deficit. During its bubble years between 1985-90, Japan's annual real GDP growth rate averaged 5 percent, as against 2.7 percent in the last five years for the U.S. economy. Annual productivity growth averaged in Japan 3-4 percent, compared with little more than 1 percent in the U.S. case. As to corporate profits in Japan, after having been almost stagnant in the earlier 1980s, they suddenly soared in the bubble years by 65 percent.

WHAT MAKES A BUBBLE: THE CASE OF JAPAN

In hindsight, it is accepted wisdom that Japan's extraordinary asset boom in the late 1980s had its chief cause not in the working of an economic miracle but in the pervasive effects of a prolonged period of excessively loose money, which started with the sharply appreciating yen, or, in other words, a sharply depreciating dollar. In order to counter the inherent deflationary effects on the economy and support the weak dollar, the Bank of Japan had slashed its discount rate to 2.5 percent, until then its lowest rate ever.

Yet, this loosening of the internal monetary reins is only part of the story. Ample domestic money and credit creation was massively supplemented by soaring capital inflows as Japanese corporations shifted to ultra-cheap foreign sources, running into hundreds of billions of dollars, of which a large part ended in the Tokyo stock market. This shift in corporate borrowing had a further far-reaching consequence. Starved of their traditional lending business, the banks switched their lending aggressively to other sectors, especially real estate, stoking thereby a building boom and rampant real estate inflation.

Another critical feature in the developing scenario was, last but not least, a substantial portfolio shift of private households out of low-yielding bank deposits and into investments with trust and insurance companies, which, in turn, channeled the money into real estate financing and the securities markets.

What confused and misled most observers, including the Bank of Japan, was the impression that stock and land prices soared in splendid isolation from the goods and service prices which conveyed no signs of inflation. Few understood or realized that the stability of these prices obscured the fact that the booming asset markets nevertheless strongly impacted the economy. Asset prices tend to overstimulate domestic demand. In this way, the wealth effects on the stock portfolios overstimulated consumer spending, while the plunge in capital costs overstimulated corporate investments. After the event, it has been officially estimated that the asset bubble had boosted consumption by a cumulative 2-4 percent of GDP in the second half of the 1980s, whereas the impact on business fixed investment may have been as large as 10 percent of GDP, most of that proving later as malinvestments.

THE ESSENCE OF A BUBBLE

This, indeed, is the essence of a "bubble economy" (courtesy of Austrian theory): that soaring asset prices tend to boost demand components either through the wealth effect or overinvestment. In this way, the asset inflation is transmitted to the real economy, creating unsustainable bulges in demand and output. In Japan, where the financial system is traditionally geared to finance business borrowing and investment, the asset bubble translated

overwhelmingly into booming investment expenditure in real estate and plant and equipment, which promptly collapsed when the bubble burst.

Currently, in the United States, in contrast, where the financial system is traditionally geared to finance consumption, the bubble effect on the economy is overwhelmingly in booming consumer spending. Oddly, even though the record-high valuation of corporate stocks implies a tremendous lowering of the costs of equity funding, one should expect heavy issuance of shares. Yet, exactly the opposite is happening. Corporate management finds it more important to push their shares prices by large-scale buying of their expensive shares in the wake of mergers and buybacks. Raising shareholder value at any cost and as fast as possible has absolute priority.

By the way, the U.S. stock market bubble of 1927-29 had the very same distortive effects on the economy. During those years, consumption had accounted for well over 90 percent of GDP growth. Thus, when the stock market crashed, it hit a highly imbalanced economy and an overextended consumer. American economists, who identify inflation exclusively with rising CPI and PPI inflation, have never understood the connection between the bubble-related consumption binge and the following depression. For the economists of the Austrian School just this was its chief cause. In this light, we find it remarkable that the current U.S. economic recovery, too, has been more consumer-driven than is generally appreciated, accounting for 69 percent of the cumulative growth in real GDP, well above the 60 percent average of the past four upturns.

Turning briefly back to Japan's bubble of the late 1980s, it is in hindsight clear that it was fueled by an uncanny confluence of unusual, yet inter-related changes in the financial structures. Prolonged excessive monetary looseness and the expectation of its continuation in the long run were definitely the crucial underlying condition. But there was more to it.

In the first instance, there occurred a massive shift of corporate borrowing away from banks and toward foreign sources and the domestic securities markets. This shift forced the banks into alternative lending outlets. The other critical change was the already mentioned massive shift in household savings toward trust and insurance companies and thereby into indirect securities investments. The net result was rampant money and credit creation in the direction of asset markets.

Not only investors, but more importantly the Bank of Japan, felt most comfortable with this development. Above all, the absence of CPI and PPI inflation was taken as a sign of non-existing inflationary pressures. This gave the vertical rise in stock prices the appearance of a healthy, sustainable relative price adjustment in response to a steep fall in interest rates and the ensuing skyrocketing profits. Belatedly, after the bubble had burst, it was realized that the profit boom, too, had been a mirage. What had inflated profits were the one-time steep decline of interest rates and so-called *Zaitech*, that is financial engineering and speculation, rather than rising efficiency.

THIS BOOM IS GLOBAL — BUT LED BY WALL STREET

Now to the present boom. The first thing to see is that it is unique in that in engulfs virtually the whole world. The only exception are the Far Eastern Tiger countries, which are struggling with their own, special bubble problems. Unique, as well, is the scale of the rises in stock prices that haven taken place over the last twelve months.

Nor is it only stock markets that have been swept by this unprecedented tidal wave of money. Bond and credit markets experienced just the same flooding, strikingly exposed in the global collapse of yields, spreads and risk premiums. Given a general desperate search for a better return, any financial junk from anywhere finds ready buyers accommodated by an apparently limitless availability of money for the purchase of financial assets, without spilling over to the prices of goods and services.

Yet even though the bull run of financial markets is global, there is no question that Wall Street is the bellwether

in many ways. It importantly contributes to the boom psychology, and it has set the ever higher valuation parameters, not to speak of the hundreds of billions of dollars that American investors and speculators have in recent years been pouring into global financial markets.

As U.S. stocks are hitting ever new highs, Wall Street's relentless mantra is that everything has its sound foundation in the picture-perfect conditions of the U.S. economy, not seen since the golden 1960s: new monetary and fiscal discipline, new corporate lean-and-meanness, and an unprecedented high tech boom — all together assuring higher long-term economic growth with low inflation, rich profits, and ever higher equity valuations.

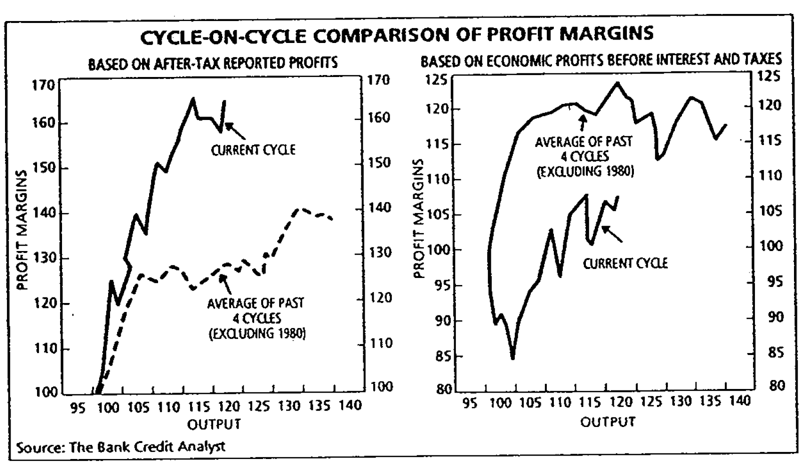
Precisely as in the late 1920s in America and again in the late 1980s in Japan, the unusual coincidence of strong economic growth and low inflation is seized upon as conclusive evidence that the zooming bull market in stocks must have solid economic underpinnings, fully justifying new heights in the market valuation of corporations. We suspect, though, that the strong bullish impact of the low inflation rates on the markets has in addition quite a different main reason, namely, the realization and calculation that they act as an insurance against any surprising rate hike, flashing a green light for unrestrained speculation.

A GLOBAL COLLAPSE - IN INFLATION RATES

Even though the monthly U.S. inflation rates have for some time regularly come in at the low side of expectations, Wall Street nonetheless is every time making the same maximum fuss about it. This is hailed as the result of Mr. Greenspan's superior monetary management. Hardly ever is it mentioned that inflation has sharply receded to its lowest rate in a generation, not only in the U.S., Japan and Germany, but also in such countries as Italy and Brazil — countries long noted for extremely high inflation. Italy's CPI inflation rate is down to 1.4 percent, from 5.5 percent in early 1996. As to overall CPI inflation in EEC Europe, it has fallen in a straight line from a peak of 6.4 percent near the start of the decade to recently 2.1 percent. Excluding Greece, the rate is closer to 1.5 percent. There is, in this light, absolutely no reason to celebrate the present low U.S. inflation rate as a particular achievement of the infallible Mr. Greenspan.

PROFIT HALLUCINATIONS

Besides lower interest rates, the other main propellant of the roaring stock prices were soaring profits and the expectation of more of the same for some time to come. True it is that, measured by reported profits per share for the S&P 500, U.S. corporations exhibited in the 1990s their steepest profit gains. They more than doubled between 1991-1996. For Wall Street, this unusual profit bonanza is the self-evident fruit of extended corporate restructuring marvelously boosting both productivity, and profits. It has become Wall Street's gospel that this profit boom is the logical response to years of unusual efficiency gains through massive corporate restructuring, implying that similar profit gains will continue far into the future — 15.5 percent per annum according to IBES — justifying ever soaring stock prices.



Source: The Bank Credit Analyst

Past and future profits are precisely our bone of contention with Wall Street. The first thing to see is that the trend of reported corporate profits is vastly in excess of the profits as reported in the national income accounts (NIPA), published by the Commerce Department. The former rose around 100 percent between 1991 and 1996, the latter just 65 percent.

What's more, between the end of 1991 and the present, those gains in profits compare with much steeper rises of the stock indexes: Dow +156 percent , S&P 500 + 125 percent, and NASDAQ + 168 percent . Measured against NIPA profits, market valuations have substantially more than doubled. To say in the light of these facts that the bull run in U.S. stocks is well supported by underlying profit growth appears rather fanciful.

Since the beginning of the current phase of the extraordinary bull market at the end of 1994 and through the first quarter of this year, the divergence between the rise in profits and the rise in valuations has been going to new extremes, with profits from the national income account up just 12 percent, earnings per share up 26 percent and the S&P 500 index up 65 percent.

In earlier letters, (in particular October 1996, False Profits Revisited) we have explained something even more important than this increasing divergence between profit growth and their valuation. That is the circumstance that this supposedly unprecedented profit boom celebrated by Wall Street is really a hoax.

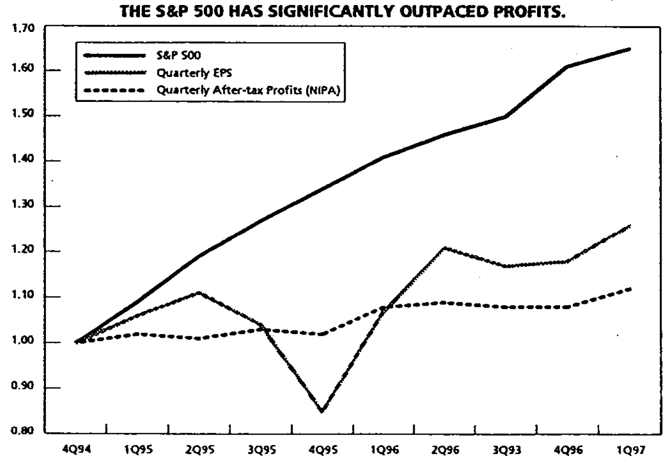
It's an easily verifiable fact that U.S. business profits have in the 1990s immensely benefited from factors that have nothing to do with operational efficiency. These were plunging interest costs, a substantial decline in the effective tax rates, sluggish growth in depreciation changes and increasing use of stock options for employment compensation. If these effects are stripped away, profit growth in this cycle has actually been the lowest in the whole post-war period.

NO DOUBT, THIS IS A "BUBBLE"

This financial boom is global, yet we have focused on Wall Street's boom and the U.S. economy because they are the bellwether for the rest of the world, partly through psychology, partly through setting ever higher valuation parameters, and partly through heavy American speculative activity in the rest of the world. Wall Street mantra, though, has it that the stock market boom is sustainable as it reflects new economic health. To quote Abby Joseph Cohen, co-chair of the Investment Policy Committee of Goldman Sachs: "Recent gains (in the stock market) are well supported by fundamental developments."

Our answer to this statement is twofold: first, as to the U.S. economy, the disclosed sub-par trend in the underlying profit performance flies in the face of all the talk about a "new" American economy; and, second, looking at the rest of the world, there is far more economic weakness than economic success. Yet the markets are booming as well. Russian stock prices are this year's and last year's star performer — up almost 500 percent in the last 19 months! This certainly testifies to an indiscriminate global bull market that must essentially have a common global cause, and that cause is obvious to us: unprecedented global monetary looseness fueling unprecedented global financial speculation.

SINCE THE BEGINNING OF THE BULL MARKET AT THE END OF 1994, THE S&P 500 HAS SIGNIFICANTLY OUTPACED PROFITS.



Source: Welt Research; US Dept. of Commerce, Survey of Current Business, Jan/Feb 1996; May 1997; Standard & Poors

Still, hasn't the U.S. economy in the last two years performed considerably better than expected, and also far better than most other major industrial countries? Sure, but two years hardly justify talk of "spectacular fundamental improvement". On closer look, we recognize two specific characteristics of a "bubble economy".

Earlier, we explained the decisive, specific feature of this kind of economy. It occurs when rising asset prices spill over to the real economy by substantially affecting investment and consumer decisions. In the

textbooks of the Austrian School this impact essentially imbalances the economy, irrespective of any associated effects on consumer or producer prices. The decisive maladjustments consist in such demand effects, not necessarily in any price effects, and in the destabilization of the financial system. Just as in the late 1920s in America and in the late 1980s in Japan, outsized bubble effects are happily (mis)taken for wondrous "New Era" effects.

FINANCIAL CATCH-AS-CATCH-CAN

This brings us to the fallacy in the quote from Mr. Abelson at the top of this letter. Listing with an ironic ring many of the marvelous things happening to the U.S. economy, he concludes: "give credit where credit is due: to the bull market". He means, of course, what we call the bubble effect. But bull markets don't happen just by themselves. They need fuel, and its abundant supply has to be initiated by the central bank. Inasmuch as somebody has to get credit for the bull market, it is indeed Mr. Greenspan.

But to maintain his monetary looseness, Mr. Greenspan has himself been dependent on the foreign central banks, who with their persistent huge dollar purchases have readily accommodated the huge chronic gap in the U.S. balance of payments. Through their massive purchases of U.S. Treasuries, these largely Asian central banks are, in reality, the ultimate guardian angels of the prolonged global financial boom. Without their apparently unlimited dollar support, Mr. Greenspan would long ago have been compelled to slam on the brakes, from which nothing but a crash and very depressive effects could have emanated. The stunning fact is that total dollar reserves of world central banks rose over the last three years by nearly $400 billion, to $1,050 billion.

Still, just as it was some years ago in Japan, it is wrong today to look only at the central banks as the instigators of this financial mania. Generally speaking, central banks propose, but the financial systems dispose. The actual degree of impact from monetary looseness on an economy and markets hinges entirely on the specific way the financial system responds and the intensity of its response, which may, in fact, vary in the extreme. Behind the frenzied development in the financial markets in the past years are, most importantly, sweeping changes in the business environment and financial structures, the latter resulting largely from rapid progress in financial deregulation, innovation and globalization and the general weakening of the business cycle.

Those changes, which we shall specify, have had two chief effects: first, they have immensely enhanced the power of the world financial system to create money and credit flows virtually without limit (not only that, it is done with abandon); and, second, associated with this unbridled monetary overexpansion has been a drastic redirection of the flows of funds toward financial asset markets, more and more of it really financial speculation

Instrumental to this wide opening of the money spigots in favor of financial speculation were in particular two global trends: first, explosive growth of the international so-called repo market, where interbank borrowing and security purchases have been collateralized by securities; second, explosive growth of loan securitizations, that is the pooling and repackaging of loans into securities which are then sold to investors and speculators. Most importantly, this spreading practice has freed banks and other institutional lenders from the former capital-ratio restraints while also bullishly boosting reported profits. A whole new breed of non-bank lenders has flourished through aggressive lending and securitizations. Monetary catch-as-catch-can rules the global financial world.

To complete the picture, it needs mentioning that these financial trends have been distinctly intensified by critical changes in the finances of corporations and private investors and the investment behavior of savers. As to corporations, their capital expenditures have generally declined to the levels of current cash flows and lower. External financing of new real investment has largely disappeared. The corporate borrowing that takes place is overwhelmingly devoted to the financing of mergers and acquisitions or, in the United States, also to repurchases of

outstanding shares. This shift in credit demand coincided with a major portfolio shift on the part of investors out of low-yielding bank deposits and into the booming securities markets.

Wondering more and more about what is propelling this financial mania, we see yet another reason that has importantly contributed to the dramatic transformation of the financial system. That is a virtual collapse in the profitability of bank lending, as deregulation, innovation and globalization have unleashed fierce competition through short- and long-term securitization, devastating the profit margins in the traditional bank business. Faced with the need to open up alternative profit sources, the banks turned aggressively to investment banking. Given natural limits to the financing of economic activity, this resulted instead in exploding financial activity, most of it outright speculation.

There are no statistics to capture total speculative flows across the world. However, we find the development of international financing, collected by The Bank for International Settlement (BIS), a valuable indicator. According to the these statistics, net credit creation in the international markets through banks and the securities markets amounted last year to $745 billion, having tripled since 1992. That is many times what could have been absorbed by the financing of economic activity.

THE DOLLAR STANDARD AT STAKE

It is now becoming apparent that both economists and Wall Street economists completely misjudged the performance and the strength of the Asian tiger countries, mistaking bubble economies for healthy economic miracles. Sliding currencies and stock markets, plunging exports and economic growth rates have besieged what were only recently considered economies with the strongest fundamentals. After years of tying their currencies to the dollar, thus stimulating huge capital inflows, massive investments in manufacturing, and spectacular economic growth, these bubble economies are now paying the bill for the resulting big maladjustments in their economies and financial systems.

Beginning with the financial and currency troubles of Thailand and a sliding Thai Baht, contagion effects quickly embroiled not only the whole region but developing countries worldwide. Though geographically far apart, there is one common denominator consisting of two facts: first, linkage of the currency to the dollar; second, large current-account deficits. In short, the global dollar standard is at stake.

So far, the recent currency devaluations have been modest, except for the Thai Baht, which has plummeted by 20 percent. This compares, though, with the disastrous 50 percent drop of the Mexican peso in 1994. But these limited declines largely reflect desperate efforts by the governments to shore up their bruised currencies, partly through capital controls, partly through interventions in the currency markets. Spectacular first major victims of the currency troubles are the stock markets in these countries, with skids of more than 20 percent.

The ramifications of these financial and currency turmoils are complex but, we believe, of utmost importance. Is this only a "bump in the road" for these countries? What are the short-term and long-term ramifications for the dollar, of which the central banks of these countries have been major buyers in the past years. What are the ramifications for Japan, which has outstanding bank loans to this region of more than $150 billion. What are the ramifications for the global financial markets?

A CLEAR CASE OF BUBBLE ECONOMIES

In contrast to the general admiration for the economic performance of the Asian tiger countries, we have always expressed our doubts and increasingly critical views. In the September 1996 letter we said: "What makes the Asian tigers so interesting is that they are universally seen as an outstanding healthy group of countries with the brightest future ahead of them. In fact, they may be teetering on the edge of a cliff."

In the March 1997 letter, we analyzed the precarious situation of these countries in greater detail. There is little to add to what we wrote then. Basically, the woes of developing Asia are of the Japanese variety. To prevent huge money inflow from appreciating their currencies and hurting their export competitiveness, their central banks have been accumulating dollar reserves at a furious pace, rocketing in the 1990s from $150 billion to $450 billion. This dwarfs Japan's enormous dollar hoard of now $220 billion.

The essential primary effect of these huge dollar purchases by the central banks was artificially low interest rates and runaway money and credit expansion. The ultimate effects on the economies were all those that are typical of a bubble economy: rampant financial speculation, and vastly excessive investment in industrial plant and real estate. In several countries, banks and corporations became over-reliant on short-term, unhedged foreign currency debt. Severe misalignments in the economies coincide thus with severe mismatches in the currency structures of the systems' assets and liabilities.

We further said: "Considering their high savings and investment ratios, these countries greatly resemble Japan. But looking at their balances of payment, the striking similarity is with Mexico." While Japan pricked its bubble by means of monetary tightening through its own central bank, the bubbles of these countries are pricked by currency troubles and flight of foreign money.

Many commentators were quick to assure that these financial and currency troubles of the tiger countries are sure to be overcome soon and that this is the time to buy the stock markets of these countries on their "dips". Complacency all over. This may prove right but, in our view, the economies and financial systems of these countries are far more misaligned than is generally realized. More than a decade of surging economic growth has blinded domestic policy-makers as well as foreign investors to the numerous, serious shortcomings of these economies, such as stressed-out banks, overheated property markets, huge trade deficits, a glut of factories, and stiffening competition from China.

Japan's economy hit the wall when its banking system cracked under the weight of exploding bad loans to overextended real-estate developers, and Japan's economy has been struggling to recover ever since. Now the same malady is spreading to the rest of East Asia. There are estimates that the nonperforming loans in the region exceed $600 billion. If they are allowed to fester, Asia's banks could be trapped with drastic capital losses that would severely crimp their ability to make new loans. The bill for many years of too easy credit is coming due.

Throughout Southeast Asia, economic recovery will be hindered by the resulting weakness of the banking systems. Unless policy-makers will quickly establish ways for banks to securitize and unload the bad loans on government institutions, as happened in the United States, some of these countries may well run into worse trouble than Japan because in their case there is one extremely aggravating factor: the huge current-account deficits and the high dependence on large foreign money and capital inflows.

Still, there is one thing that we have misjudged: the dollar. Considering the large dollar purchases by the foreign central banks of these countries, it seemed self-evident that any currency troubles would lead to heavy dollar sales by these countries, thereby weakening the dollar. What has happened, instead, is that such dollar selling by the central banks has been more than offset by the heavy dollar buying of banks and corporations rushing to cover the exchange risks in their huge dollar liabilities that run for the whole region into several hundred billion of dollars — strengthening the dollar. How it works out in the long run is difficult to say. For sure, it weakens the dollar standard.

For the time being, there is one thing that is importantly easing the situation, and that is U.S. monetary looseness. In the late 1970s, it was Paul Volcker's fierce monetary tightening that turned the Latin American debt and currency crisis into a full-fledged disaster.

AN INVULNERABLE U.S. EXPANSION?

At the start of this letter, we posed the question, what is chiefly stoking this runaway, global financial boom — economic success or loose money? Economic success has, in this world, clearly become a rarity. The answer is thus self-evident: nothing but loose money. But what about the "new" U.S. economy?

To be quite frank, all the talk of this kind is of depressing superficiality, in particular when it comes from a central bank president. To begin with, we have to note that U.S. GDP growth in this cycle has been quite anemic, averaging 2 percent per annum. The current widely admired growth spurt is just one year old. And as to the strong employment growth, that is the U.S. economy's outstanding hallmark for decades. All this hardly gives reason to speak of a "new" economy.

What we, however, see are overwhelmingly the deceptive characteristics of a "bubble" economy. The traditional American view has it that inflation begins and ends with rising consumer and producer prices. In contrast, the traditional European view before Keynes, largely determined by the Austrian School (Mises, Hayek, etc.), has it that the essence of inflation is not in the behavior of the conventional price indexes but in a glut of money and credit flows calling forth all kinds of distortions and maladjustment in the economy and its financial system. This was their interpretation of the U.S. stock market boom in the late 1920s and the following depression.

Looking at the U.S. economy through these glasses, we observe a whole list of major inflationary symptoms and imbalances:

1) a flight out of cash and into securities associated with rampant financial leveraging through carry trade and derivatives;

2) the perennial, large current-account deficit, reflecting chronic overspending relative to potential domestic output;

3) overspending by consumers fueled by runaway debt and wealth effects;

4) a grossly imbalanced investment structure (overinvestment in high tech and consumer-related services, otherwise chronic underinvestment);

5) astronomic growth of pure paper prosperity accruing from capital gains and an exploding stock of securities that are not backed by physical assets, as against abysmal real net capital formation;

6) enormous tax windfalls for the Treasury from capital gains in the soaring stock markets;

7) profit distortions and manipulations.

Measured by total U.S. flows of funds into domestic economic activity, into domestic financial asset markets, and through the external current and capital account into the rest of the world, the United States has for years the most rampant inflation of all times, but their massive diversion into the financial markets and into the rest of the world has created a mirage of stability by leaving the price indexes untouched. That was the view of the Austrian School about the U.S. experience in the 1920s, and that is our view of the situation today.

Still, it is impossible to say when a "bubble" economy will finally hit the wall, and what will be its cause, if not monetary tightening. The truly "new" situation of the 1990s is that languid economic growth and low inflation rates globally are keeping serious monetary tightening at bay as far as the eye can see, and this, in conjunction with deregulation, innovation and globalization, is promoting the most reckless and the most global financial speculation that the world has seen.

EMU GYRATIONS

Currency markets and ebullient stock markets in Europe are betting on a "wide" and "soft" euro in 1999. Two considerations, in particular, are seen to support this expectation: first, the proven stubbornness of Mr. Kohl in pushing through his wishes; and, second, that the movement toward a single currency has already proceeded too far to be stopped without cataclysmic effects on currencies and financial markets, for which nobody can want to be blamed.

We think, both arguments are seriously flawed. True, Mr. Kohl has in various important questions got the better of strong opposition, but never before has he met such strong public involvement and resistance as in the euro case, and not to overlook further, this is a drastically weakened Mr. Kohl. By now, three prime ministers (Stoiber, Bavaria; Schröder, Lower Saxonia; and Biedenkopf, Saxonia), leading figures in the German political world, are openly demanding delay. Our own expectation of the currency union being aborted has chiefly been pinned on the probability of veto by the German Constitutional Court. We hear the argument that its decision would probably come too late, after EMU has been implemented. To this, our first point is that there is a long interval between the first decisions and planned implementation. The Commission decides in March, and the governments in May. And, second, what really happens with the day of implementation? Little more than what is happening today. Until the introduction of euro notes in 2002, essentially the national currencies will prevail.

Defenders of the euro try to intimidate their opponents with frightening stories about the currency turmoils that would ensue if the euro were to be abandoned. In vain, we think. As to the threat of a disruptive sell-off in bonds of "peripheral Europe", it has been much diminished by the impressive progress of fiscal consolidation in quite a number of countries. And, as to the "danger" of a sharply weaker dollar, the euro antagonists rather regard it as a desirable correction of its present overshooting, owing largely to speculation on a "soft" euro.

CONCLUSIONS:

To be sure, the present global cycle is "unique". But the extraordinary part is not a generally superior economic performance but an unprecedented glut of money and credit for financial speculation. Bubble features prevail. But with monetary tightening not in sight, talk about an imminent crash is futile, though it is sure to happen one day.

The timely start of EMU appears to us most improbable. Demanding delay for failure to fulfill the criteria has in Germany become the convenient way to camouflage opposition on principle. But market participants want to believe that it will happen. Apparently, it needs facts to change their mind. That may take a while yet.

The U.S. dollar and British pound are on a bandwagon. Both are grossly overshooting any reasonable target. But underlying ill-guided perceptions of the fundamental strengths of both economies and a coming "wide" and "soft" euro are deeply entrenched.

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